The First-World Debt Crisis of 2007–2010 in Global Perspective

Robert Wade

We do not yet know how bad the current credit crisis will get. But we do know that policies in rich nations, dominated by the United States, were often the opposite of corrective. As the author writes in this incisive review of the events that led to the crisis, while boom times rolled on, the cost of credit fell, generating pro-cyclical momentum that made matters worse. A new regulatory apparatus is needed, he argues, one that is more aggressive than is currently being discussed.

"I would place the U.S. current account [deficit] far down the list of imbalances to worry about."

—Alan Greenspan, chairman of the U.S. Federal Reserve from 1987 to 2006

From 2001 to 2007 the world economy grew faster than in any other six-year period over the past thirty years. Most developing countries shared in the boom, even including sub-Saharan Africa. In the second half of 2007, the boom turned into, if not bust, then a period of uncertainty and instability. There are still optimists, as of

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mid-May 2008, who say that the crisis is just a blip, like a champion athlete's muscle strain that will be fixed with a bit of rest and physical therapy. They emphasize that the U.S. economy has not yet had a quarter of officially negative growth; the U.S. government has launched a strong Keynesian monetary and fiscal stimulus; equities are rallying, and investors are buying new bonds; the macroeconomic impacts on Latin America, Africa, South Asia, and East Asia have been mild; fast growth in East Asia is driven more by domestic and regional demand than by U.S. demand; and continued growth in developing countries will mitigate the U.S. downturn. Their optimism reflects their conviction that financial regulators should be satisfied with pledges of more transparency and better behavior, so they should not introduce new regulatory constraints.

But many analysts without vested interests now accept that the crisis is more like a heart attack in a sixty-cigarette-a-day smoker, and that the worst is probably yet to come. Certainly the financial system is slowly working its way through the U.S. subprime shock. But a large chunk of non-subprime mortgages now look to be much higher a risk than previously thought. And as the U.S. economy and parts of Europe slow down, a second wave of defaults will probably arise from corporate and consumer debt, creating a slow-burning vicious circle between finance and the "real" economy. The governor of the Bank of England recently captured the mood when he declared that "the NICE decade is behind us," where NICE stands for "non-inflationary continuous expansion."

Yet even if the optimists turn out to be right—even if "we are closer to the end than the beginning," to quote Treasury Secretary Henry Paulson in May 2008—the crisis has already made history as the first time that hopes are pinned on growth in developing countries to rescue the world economy, and the first time that troubled banks in the United States and Europe have been rescued by capital injections from developing countries. Moreover, the crisis has already questioned the right of developed countries to dominate the "High Command" of global financial governance, by exposing its disorientation and powerlessness and by opening the curtain on a plethora of imprudent practices in the markets it was meant to be supervising. Perhaps the

crisis will be seen in retrospect as a milestone en route to the end of the free-market consensus and the me-too politics that underpinned it, and the end of the United States' and G7's self-appointed right to set the agenda of global business on their own.

This essay first presents some of the evidence in favor of the view that the crisis will turn out to be worse than a blip. Then it discusses the causes. The third section draws lessons for regulatory reform. The last section looks ahead to what the "High Command" is likely to do in practice, and to the U.S. and the G7's role as the center of global economic governance.

How Bad Will It Get?

Carmen Reinhart and Kenneth Rogoff look at the crisis in relation to eighteen previous banking crises in industrial economies since World War II.[1] They calculate that after the average crisis, real per capita output fell by more than 2 percent and return to trend took two years. Taking only the five worst postwar crises (in Spain, Norway, Finland, Sweden, and Japan), they find that the average drop in annual output growth from peak to trough was 5 percent, and growth remained well below the pre-crisis trend for more than three years.

They compare trends in house prices, equity prices, and the external deficits for the United States in the past several years against averages from the previous crises (see Figures 1–3). They find that the run-up in U.S. housing and equity prices was substantially higher and the U.S. external deficit in relation to GDP substantially bigger than in previous crises. The U.S. external deficit at its peak accounted for more than two-thirds of the world's current-account surpluses.

The fact that U.S. house prices rose far more than in the "Big Five" crises (Figure 1) is especially significant, because it suggests that U.S. house prices still have much farther to fall. As long as house prices show no signs of bottoming out, it will be difficult for financial markets to return to normal, and consumer confidence will remain low. Goldman Sachs and Lehman Brothers both see U.S. house prices not bottoming out until late 2009.

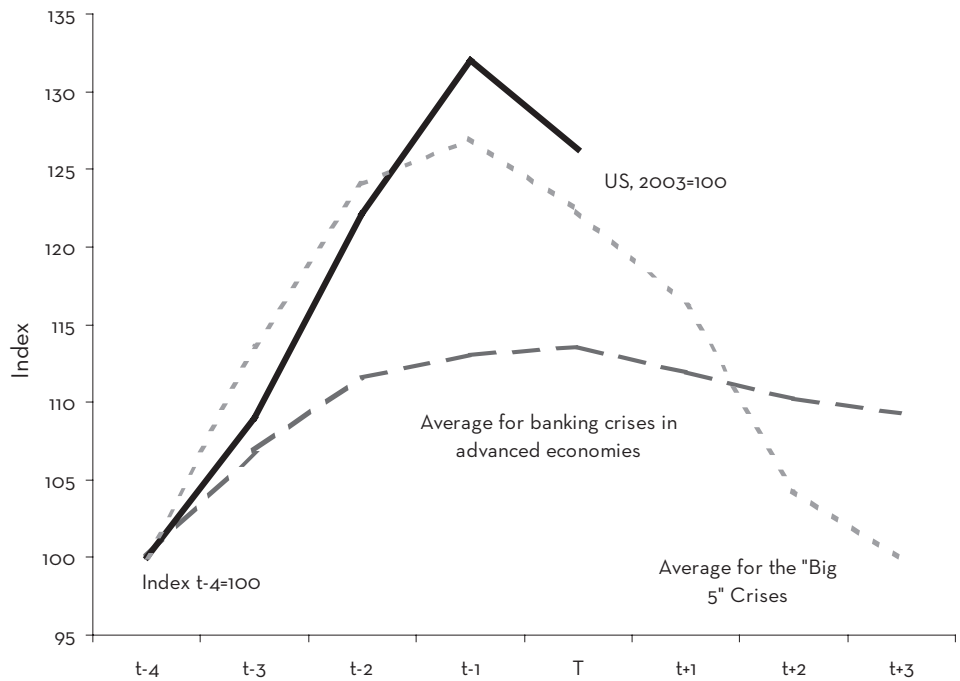

Figure 1. Real Housing Prices and Banking Crises

Source: Reprinted with permission from Carmen Reinhart and Kenneth Rogoff, "Is the 2007 Sub-Prime Crisis So Different? An International Historical Perspective," *American Economic Review* 98, no. 2 (May 2008).

Not only were trends in U.S. house prices, equities, and the external deficit worse in the run-up to the crisis than in previous industrial economy banking crises, other indicators were also flashing red. Average household debt relative to income was at record levels, and over a quarter of households were in "net asset poverty," with insufficient assets (including houses) to sustain current expenditure for more than three months in the absence of employment.[2]

Currently, banks remain under intense balance sheet pressure and are trying to offload, at almost any price, billions of dollars of "ghost assets" that cannot be embodied in real assets. More stress comes from the falling dollar and the associated rise in inflation expectations.

Soaring global food prices in the last months of 2007 and the early months of 2008 make what the UN World Food Program describes as a "silent tsunami." The world price for rice tripled between April

2007 and April 2008. Food riots have occurred in at least thirty-three countries, including China, Tibet, the Philippines, and Haiti. The prices of other commodities and energy have also soared.

It looks like a perfect storm. There are simultaneous crises in property, credit, banking, foreign exchange, food, commodities, and energy. Consumer and investor uncertainty is driving a rapid slowdown at the same time as uncertainty causes firms to be only about half as responsive to monetary and fiscal policy stimulus as compared to normal times. Taking only the United States and closely aligned economies like that of the United Kingdom, we can be fairly sure that the worst is yet to come and that growth will remain below trend for at least two years. The optimists stress that the macro impacts on the rest of the world, including most of continental Europe, have been mild, which leaves open the question of whether this is because the lags have not yet worked themselves through or because the rest of the world has indeed largely escaped.[3]

Causes

The immediate causes of the crisis are clear enough. At the center is "excessive debt leverage" or "imprudent lending," much of it in the form of complex structured credit securities that allowed banks, hedge funds, and the like to create assets composed of corporate and mortgage-backed bonds and then sell them to others, transferring the risks of borrowers' default to the buyers. Much of it was held off–balance sheet in ways not legible to investors and regulators. At a certain point in the run-up of U.S. debt relative to ability to repay, a tipping point was reached. Then anxiety about the high default risk of some financial assets and uncertainty about the location and size of potential losses made lending organizations reluctant to extend more credit to many would-be borrowers. The previously liquid market for structured credit products seized up; no one would buy, so the assets could not be priced. Financial reporting standards require firms to reduce the value of loans whose recoverability is doubtful and to alert the market to the higher risks. The write-downs—and the uncertainty about how much to write down

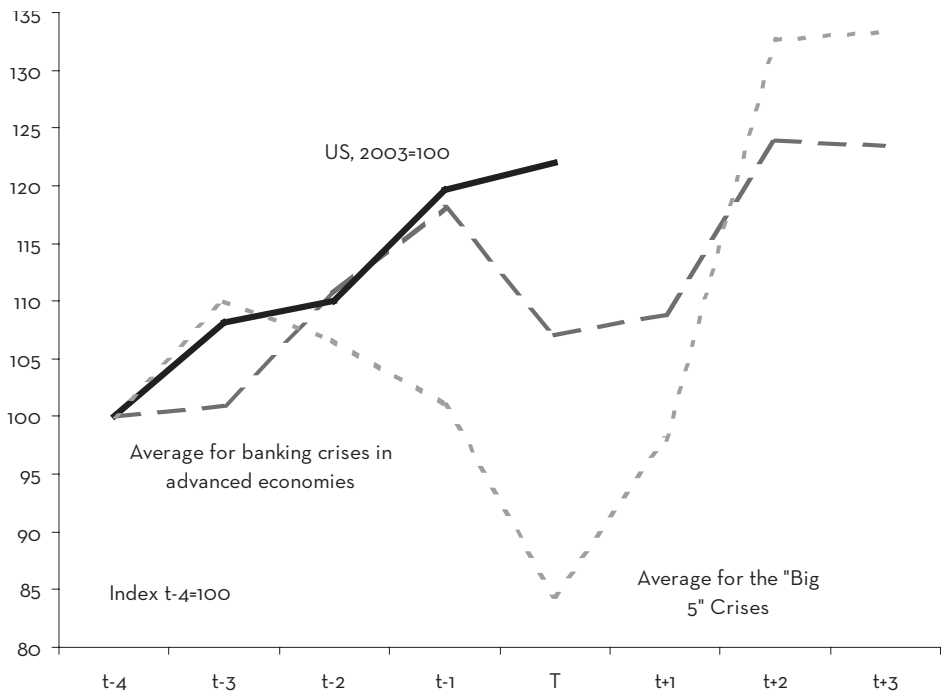

Figure 2. Real Equity Prices and Banking Crises

Source: Reprinted with permission from Carmen Reinhart and Kenneth Rogoff, "Is the 2007 Sub-Prime Crisis So Different? An International Historical Perspective," *American Economic Review* 98, no. 2 (May 2008).

in the absence of plausible market prices—intensified a vicious circle from credit retrenchment to no credible prices to low liquidity.

How did we reach this state of affairs? The crisis can be understood in the context of fundamental changes in the capitalist world economy over the past three decades, especially changes in the size and role of capital markets. These changes produced at least six deep causes or facilitators, which combined to raise the general level of global financial fragility. At this elevated level, small events can trigger much bigger effects, and economic agents become less responsive to countercyclical policy. The deep causes are analogous to the build-up of tectonic tension along a fault line, which is suddenly released in an earthquake:

1. Changes in the structure of the U.S. financial sector going back to the late 1970s–early 1980s, including the shift from net margin banking to "originate and distribute" banking.

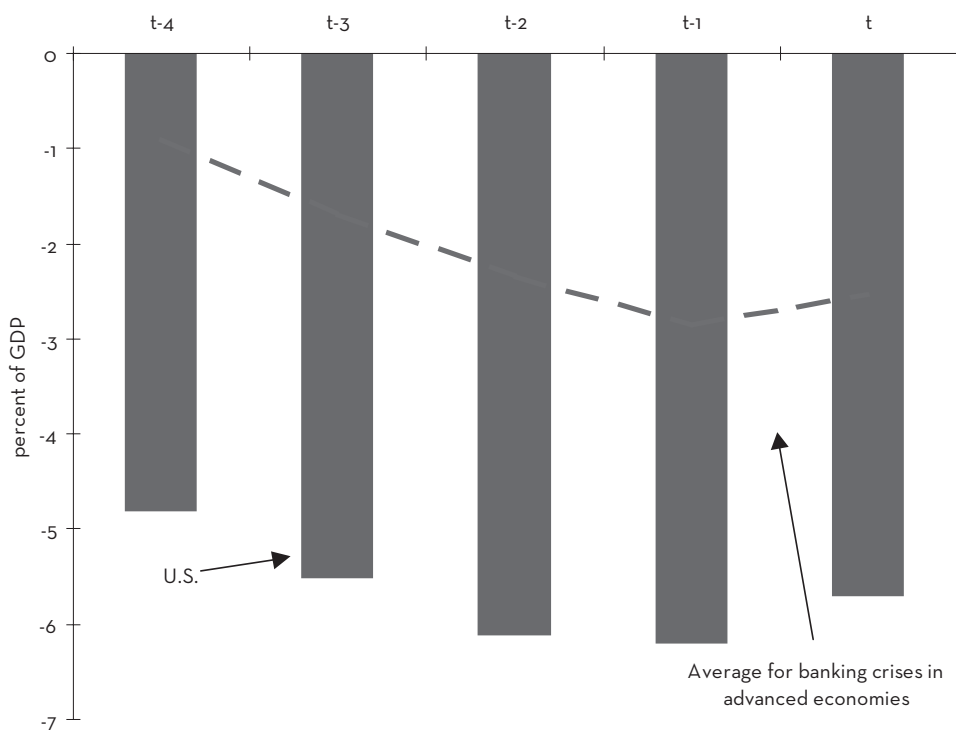

Figure 3. Current Account Balance/GDP on the Eve of Banking Crises

Source: Reprinted with permission from Carmen Reinhart and Kenneth Rogoff, "Is the 2007 Sub-Prime Crisis So Different? An International Historical Perspective," *American Economic Review* 98, no. 2 (May 2008).

2. A fragmented and light-touch U.S. regulatory regime.
3. U.S. macroeconomic policy, and in particular the wave of liquidity launched by U.S. monetary authorities in response to the dot.com crash in the late 1990s–early 2000s.

These U.S.-centered causes interacted with broader ones related to economic globalization and the international financial regime.

1. A vast increase in the global credit pool on the one hand, and downward pressure on consumer price inflation on the other. These factors reflect the combination of China's rise as the dominant exporter of everyday consumer goods and major contributor to the global credit pool, plus the United States' rise as the world's biggest debtor economy and another major contributor to the global credit pool.

2. Perverse interaction between financial markets and foreign exchange markets.
3. An overcomplicated and ineffective global regulatory structure.

From Net Margin Banking to "Originate and Distribute"

Prior to the late 1970s, commercial banks created credit money primarily for the "real economy" of industrial activity, with dedicated banks for special purposes (e.g., building societies or thrifts for mortgage lending and other activities). Their planning was linked to forecasts of the real economy, and finance ministries could regulate the industrial sector through the commercial banks.

By the late 1970s–early 1980s, equity markets in the United States began to rise, partly due to the inflow of funds from the wave of recently created funded pension schemes. Big companies, which had been the banks' best customers, increasingly relied on equity markets for finance (beyond retained earnings).

Commercial banks therefore found themselves "disintermediated," their earnings in decline. In response they sought to push lending into more marginal markets—including households and small and medium enterprises—and to develop new financial instruments and fee- and commission-based activities. The political and regulatory authorities obliged by lifting New Deal restrictions (including the Depression-era Glass-Steagall Act) that had limited the commercial banks to deposit taking and short-term lending. In the new regime the banks were free to go into a wider range of capital market activities than before.

The banking system that emerged from the 1980s no longer mainly served business lending and no longer mainly depended on net interest margins for its income (margins between interest paid to depositors and interest received from borrowers). It depended mainly on proprietary trading of financial assets and on fees and commissions. The Basel standard for minimum bank capital adequacy, introduced in 1988, accelerated the change by encouraging banks to shift toward activities that generated fees and commissions, against which they would not have to set aside capital.

In the new "originate and distribute" business model, the name

of the game was to create a lot of product and sell it on quickly to investors and speculators around the world—such as pension funds, the Port Authority of New York and New Jersey, and municipalities in northern Norway. The banks deployed two main strategies. One was to hunt out customers with the highest propensity to go into debt, including economically marginal people with no income, no jobs, and no assets (NINJAs). Economically marginal people constituted, in effect, a "developing country" within the United States, and the banks' strategy was parallel to the way they recycled petrodollars from the oil exporters to developing countries, especially Latin America, in the 1970s. Recycling to developing countries was precluded in the 2000s by the fact that many developing countries have been running surpluses rather than deficits, in contrast to the 1970s.

The other strategy was to maximize product complexity to conceal the risks from rating agencies, buyers, and regulators. The trick was to package up the risky loans with less risky loans in a way that made it look as though the overall product was low risk.

The key difference between this business model and the earlier net margin model was that the bank had no incentive to evaluate borrowers, because the income and principal would be repaid to the final buyer of the collateralized asset. It was only interested in its ability to sell the asset in return for a fee or commission (although the bank might sell the asset to its own off-balance-sheet investment entity). The model thereby distanced lenders from the consequences of their decision. It resulted in weakened credit assessment and impaired risk monitoring.

The credit-rating agencies played a vital role. Institutional investors such as pension funds, insurance companies, trusts, and the like were required to buy investment-grade securities, as rated by one of the nationally recognized rating agencies, like Moody's and Standard & Poor's. The ratings of these agencies came to substitute for the process of credit evaluation formerly carried out by bank loan officers and credit committees. The higher the credit rating, the easier to sell the asset to a final buyer.[4] Note that the rating agency had no responsibil-

ity for its rating. If it overrated, it suffered no consequences, except perhaps a loss of reputation in the longer run; but if all the agencies overrated, none suffered.

The originate-and-distribute business grew particularly quickly after the mid-1990s, with the elaboration of "securitization technology." The model was hailed as the font of financial innovation, which yielded both more varied and safer financial products—safer because risk could be dispersed over a wider area. Its champions interpreted "dispersed" to also mean "reduced."

It is now clear that the incentives of the originate-and-distribute model injected moral hazard—carelessness about costly consequences—into the heart of the financial system. Banks and hedge funds became careless because they were acting as intermediaries, not as principals. The credit-rating agencies also became careless because of several conflicts of interest built into their operations.

First, the seller or issuer of the security (the Wall Street bank) paid the rating agency for the rating, and therefore chose the rating agency most likely to give a high rating. This gave each rating agency a built-in incentive to overrate in order to win market share.

Second, the rating agencies had a parallel line of business giving advice on how to structure financial products. Obviously their advice was affected by the hope that the products on which they advised would also come to them for rating, giving them a double stream of revenue and a double incentive to overrate.

The third conflict was the most egregious of all. Under American securities law, rating agencies were not obliged to do their own "due diligence" about the risk characteristics of the products they were rating. They were legally entitled to take the information provided by the seller more or less at face value. This gave the seller an even stronger incentive to deceive. A recent report from the International Organization of Securities Commissions (IOSCO) concluded that the agencies should have realized that the information being given to them by those who manufactured mortgage-backed securities failed the "sniff test." It missed the point that by law the rating agencies are not obliged to apply a sniff test.

The originate-and-distribute model spread from the United States to the UK and other countries of English-speaking settlement, and to parts of continental Europe (notably the Netherlands and Germany). Increasingly the banks have focused on creating credit money for operations in the financial sector, such as arbitrage: they lend to hedge funds, private equity funds, and their own off-balance-sheet vehicles for engaging in financial arbitrage, seeking to profit from divergences between market segments.

The result has been phenomenal growth of the finance sector relative to the rest of the economy, and even more phenomenal growth of profits. In 1982, financial corporations generated 8 percent of total U.S. corporate value added and 5 percent of total corporate profits. By 2007, their share of corporate value added doubled to 16 percent, while their share of corporate profits went up eight times to 41 percent. By 2006 the supercharged banking model was generating profits per employee in banking a staggering twenty-six times higher than the average of all other industries worldwide.[5]

The growth of finance and its extraordinary profits help to explain the sharp increase in the share of profits in business income in the Organization for Economic Cooperation and Development (OECD) countries since 1980 and the fall in the share of labor income (manifested in stagnating real wages). The share of profits hovered around 30 percent for decades after World War II, fell to 28 percent by 1980, then rose steadily to 36 percent in 2003. The eight-percentage-point rise in the share of profits was a very satisfactory outcome for the owners and managers of capital, and it seemed to confirm that market fundamentalism was correct.[6]

U.S. Regulatory Regime: Fragmented and Light-Touch

The moral hazard built into the originate-and-distribute business model was overlooked as the boom times rolled on, for both structural and ideological reasons. The U.S. regulatory regime grew up bit by bit, without any grand plan, and each new financial product tended to get its own regulator. As a result, well over 100 authorities now

keep watch over different and overlapping segments of the country's financial marketplace.[7] Many of the authorities get fee revenue from those being regulated (an obvious conflict of interest). The system leaves large cracks between regulated segments. Important segments have been left free of regulation, including the markets for subprime mortgages and over-the-counter (OTC) derivatives. Moreover, banks operating across international borders receive only partial regulation of their cross-border operations, partly due to the weakness of cooperation between national regulatory authorities.

The prevailing ideological climate was hostile to efforts to consolidate the regulatory system and oversee unregulated segments like the subprime market and the OTC market. Neoliberal ideology celebrated the unregulated segments as demonstrating the validity of the "efficient market" theory of financial markets, which said that markets are self-adjusting and that competition plus light-touch regulation produces efficient, innovative, and stable financial markets.

The current crisis can be seen as a "natural experiment" to test the efficient-market theory. The theory fails, because the crisis has been driven from the least regulated and most competitive parts of the financial market.[8] And the current crisis aside, the theory also fails against the record of previous crises, where state authorities have routinely intervened to save the market and protect against systemic effects. This puts the lightly regulated financial sector in the best of all worlds, where it privatizes profits and socializes losses.

U.S. Macroeconomic Policy: Monetary Authorities' Response to the Dot.com Collapse

The U.S. central bank responded to the dot.com crash of the late 1990s/early 2000s in a way that generated a huge increase in debt—or household and corporate leverage—and hence also in financial fragility. Indeed, the current crisis can indeed be seen as a legacy of the central bank's response. Under the chairmanship of Alan Greenspan, the central bank (Federal Reserve) kept short-term interest rates very low and stimulated the creation of liquidity, producing a credit-fueled

boom. Borrowing became the only sensible way to live. The debt of households, companies, and government reached record levels relative to gross domestic product (GDP). In the UK, household debt as a percentage of post-tax income hovered around 100 percent between 1988 and 2000 and then took off to reach almost 175 percent by 2007.[9]

Much of the credit surge went into the housing market (helped along by the 1986 Tax Reform Act, which left mortgage interest as the only type that could be tax deducted). Foreign central banks, as well as domestic and foreign commercial banks, insurance companies, pension funds, and the like, bought bonds of the government-sponsored mortgage lenders Freddie Mac and Fannie Mae. They also increasingly bought asset-backed securities containing mortgages issued by private lending companies. The supply of asset-backed securities doubled between 2003 and 2004, and doubled again between 2004 and 2005. The surge of credit turbo-charged the housing market.[10]

Rising demand for houses came not only from people who were previously not eligible for mortgages under the old net margin model, but also from middle-class households that discovered that—with constantly rising house prices—they could accumulate housing assets and then supplement their income by refinancing their mortgages and drawing out some of the equity. To those who worried about a housing bubble, Greenspan said that the housing market was merely experiencing "froth."

Middle-class households used the rising value of their houses to finance private health care, private education, private pensions, and the like—to finance their own private "welfare state."[11] As they exited the public welfare state, more of them swung their support to politicians pledged to cut taxes and shrink the public welfare state to no more than a backstop for the propertyless. They had no trouble convincing themselves that their rising wealth and "self-reliance" were the fruit of their own shrewd investment strategies in the context of free markets, and they tended not to see themselves as beneficiaries of rising asset markets.

These developments helped to propel neoliberal policy principles to the commanding heights of political discourse, to be promulgated

as universally valid. Western-based multilateral organizations like the World Bank and the International Monetary Fund (IMF) advanced them as the foundation for development policy around the world.

In short, U.S. macroeconomic policy through the 2000s has the current crisis as its legacy. The combination of high financial profits, neoliberal ideology, and a fragmented regulatory regime constrained regulators from acting to slow down the boom by, for example, raising reserve requirements on banks. The consensus was, "Let the market work, let financial innovation flourish, let poor people buy their own homes."

Economic Globalization

These U.S.-centered causes were complemented by more international ones. They include the spatial dis-integration of production; the growth of information technology (IT) networks, which allowed de-constructed production to be knitted together; and the growth of some developing countries as production platforms in basic and standardized industries—first in capitalist East Asia, then in China. In 1990 China exported $70 million; in 2005, over $800 million. The rise of China as the manufacturing workshop of the world has intensified global competition across a large swath of manufacturing, because of China's ability to produce at 50 percent or so of the cost of rival producers. Western companies lost pricing leverage (ability to raise prices).

The combination of large and growing U.S. deficits and large and growing Chinese surpluses generated a surge in global credit relative to gross world product (see below). Without the "China price," this might have blown up in the form of consumer price inflation. Instead, the credit surge blew up in the form of asset price inflation, including in property and financial assets, helped along by the originate-and-distribute business model and the fact that central banks are mandated to curb consumer price inflation but not asset price inflation. The house-price bubbles in the United States, the UK, Ireland, Spain, Australia, and New Zealand are just part of a more global property bubble over the past decade.

Perverse Interaction Between Capital Markets and the Foreign Exchange Market

The debt-financed boom in the United States generated by years of loose monetary policy increased the United States' already large external deficit. For a decade the United States has been spending 5–7 percent more than it produces, recently importing on the order of twice as much as it exports (see Figure 4). The deficits have been financed by fast-rising inflows of foreign capital. But for some years investors have been waiting to rush for the exit at the first sign of real trouble. As Figures 1–3 show, several indicators of approaching crisis showed the United States flashing red years ago. The only reason the United States escaped so long was that it is the United States, not Thailand—the biggest economy in the world, with the deepest financial markets, issuing the main international currency. Its central bank can repay debt by creating more national currency and more national debt in a way that no other country can.

But no country can be extended credit forever. Once the trigger was pulled, the underlying fragilities were such as to generate pervasive fear on the part of those holding financial assets, like what happens in a computer network when people hear that an aggressive virus is on the loose. The fear spread well beyond the United States because many other economies around the Atlantic and in Eastern Europe have also been running large and persistent trade deficits with the surplus producers of Asia.

Before the current crisis, the preceding long boom depended crucially on the international financial system's toleration of huge trade imbalances. Had the United States not consumed more than it produced—and borrowed correspondingly—the rest of the world would have expanded its industrial capacity and employment more slowly. The other side of the United States' fast growth of external debt is fast growth of world foreign-exchange reserves, most of which are still denominated in dollars. Total foreign-exchange reserves have doubled in the past four years, increasing by as much in this period as in the previous century (see Figure 5).[12]

The fast growth of world foreign exchange reserves fueled the global

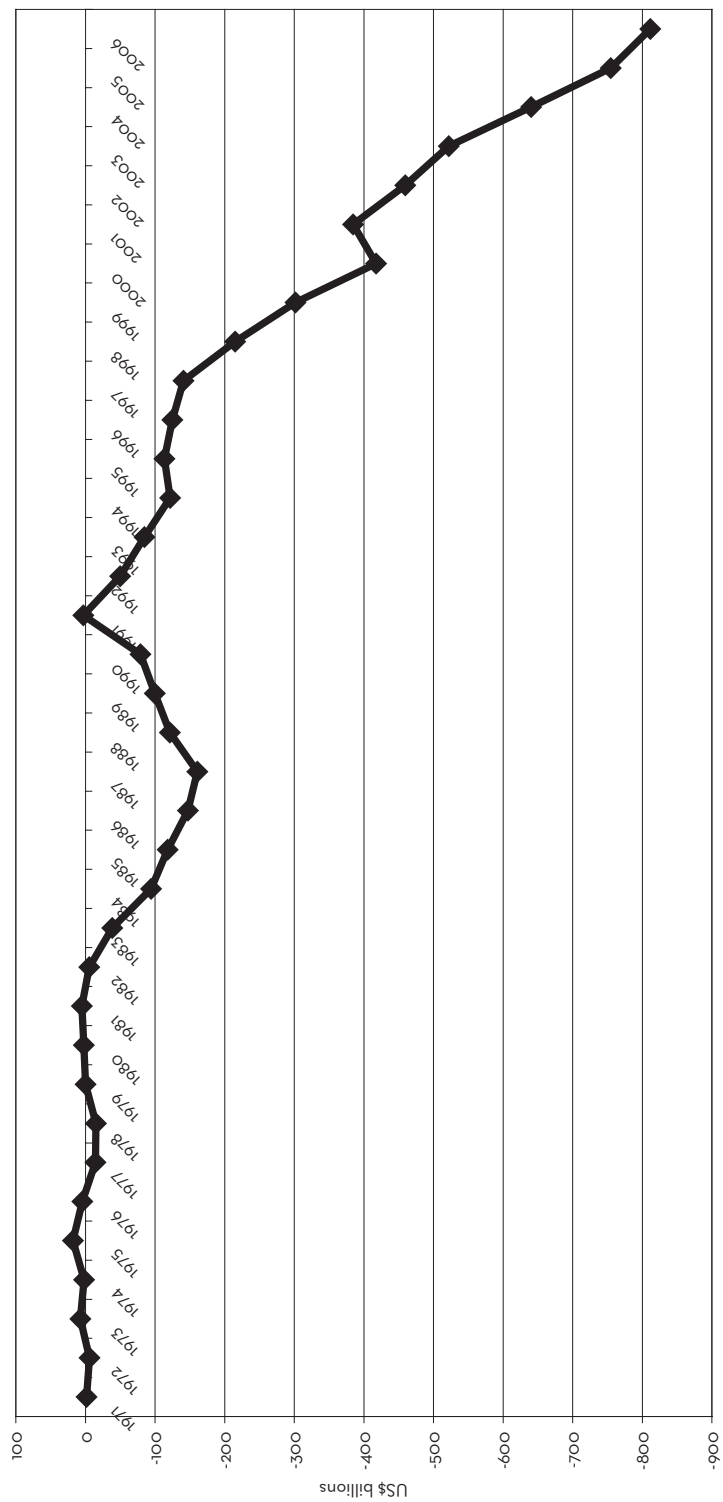

Figure 4. U.S. Current Account Balance, 1971–2006

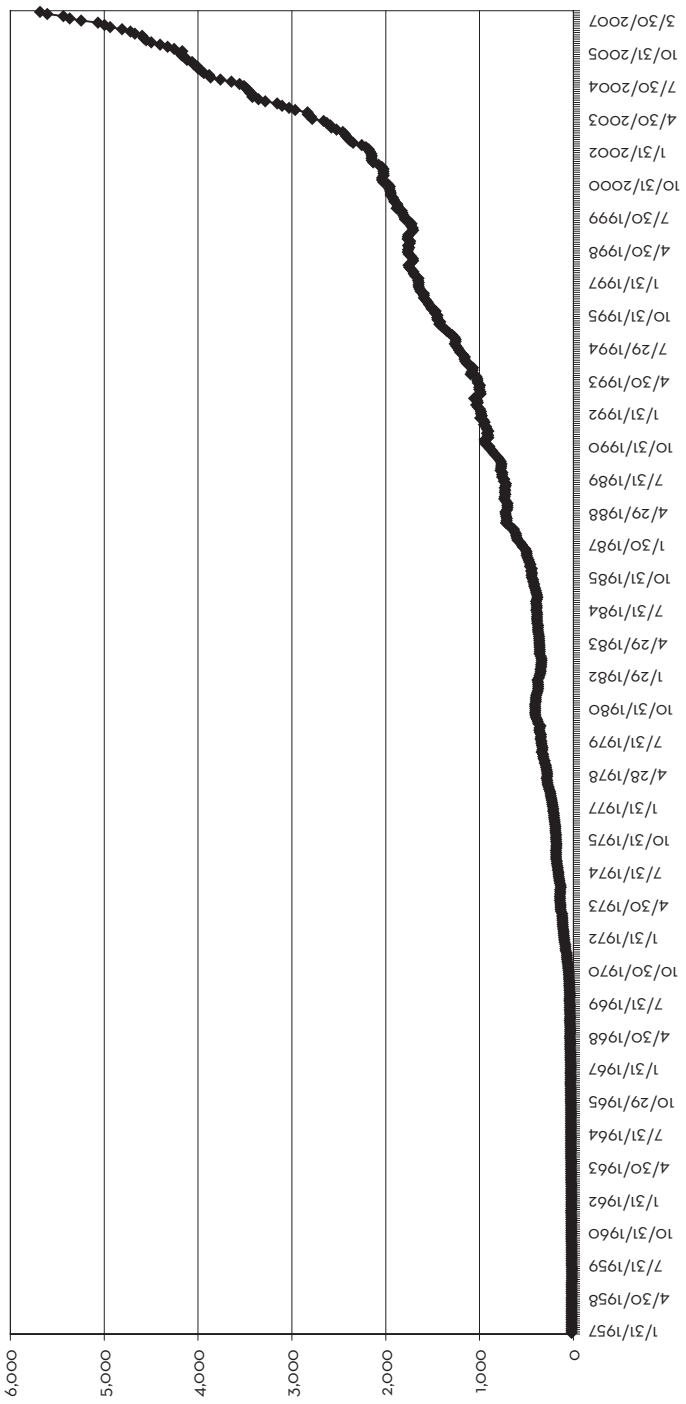

Figure 5. Total World Foreign Exchange Reserves, 1957–2007 (US$ billions)

credit bubble, which raised the level of global financial fragility. The bubble blew up first in one place and then in another, moving around the globe.

This raises the question: why do exchange rates not adjust so as to curb the external imbalances? In the simple theory that guides policy, the relative price of the currency of a large debtor country should fall, and the relative price of the currency of a large surplus country should rise, the price change prompting expenditure switches that reduce both deficits and surpluses. The market should self-adjust. Instead, we often see the opposite. Table 1 shows that in 1996–2006, countries with the biggest external deficits tended to experience appreciation of the real effective exchange rate, while countries with the biggest surpluses tended to experience depreciation.[13] In short, the market for foreign exchange combines with the originate-and-distribute model to act as an engine of global financial instability. It enables large external imbalances to persist, which then suddenly adjust as investors and speculators rush to be first out the exit.

To explain why the simple theory of exchange rate adjustment is wrong, it helps to divide the world economy into two zones. Zone 1 includes countries with floating exchange rates; zone 2 includes countries with fixed exchange rates.

Zone 1, with floating rates, includes countries like Japan and Switzerland, where interest rates are very low, and countries like Iceland, New Zealand, Hungary, and many others, where interest rates are very high—because inflationary pressure is high and the central bank is required to give priority to keeping inflation very low ("inflation targeting"). With free capital movement, investors and speculators ranging from Japanese housewives to hedge funds borrow in a low-interest currency and buy assets in a high-interest currency to reap the interest-rate differential. Their purchases can drive up the relative price of the domestic currency, earning them not only the interest-rate differential but also the currency-appreciation differential. Yet many of these high-interest-rate countries are also running large external deficits. Hence the paradox from the perspective of the simple theory of exchange-rate adjustment—that countries running large external

Table 1

Crazy Exchange Rate Movements (real effective exchange rate, 1996–2006)

		Movement of REER		
Current account	*N*	Appreciation	0	Depreciation
Deficit	18	15	3	0
Surplus	7	2	0	5

deficits experience currency appreciation, which makes the external deficit bigger rather than smaller. This is part of the reason for persisting large external imbalances and high global financial fragility.

Zone 2, the zone of fixed-exchange rates, operates rather differently, according to a regime sometimes known as Bretton Woods 2, because it has similarities to the earlier Bretton Woods architecture. It is best explained by reference to the United States and China, the two poles. China maintains a more or less fixed market exchange rate between the renminbi and the dollar, and other East Asian countries link their currency to the dollar so as not to lose competitiveness against China. China maintains a fixed rate because the central bank's top objective is nominal exchange-rate stability. The central bank calculates that China's capital market is still far too underdeveloped to absorb stably the huge net inflow of dollars in exchange for renminbi, and so it "sterilizes" the dollars in exchange for renminbi at the fixed rate.

Then the central bank uses its dollars to buy U.S. assets that earn some return, generating the return flow—noted earlier—into U.S. Treasury bills, the bonds of U.S. state–sponsored enterprises such as the mortgage lenders Freddie Mac and Fannie Mae, and, increasingly over the 2000s, AAA-rated asset-backed securities that contained mortgages.

The resulting inflow of capital has helped keep U.S. interest rates very low and also helped to turbo-charge the U.S. housing market and lure the banks into excessive risk-taking. It has emboldened the U.S. state to expand its empire network in the Middle East and Central Asia, by reducing the need to raise taxes to cover the cost of a "guns *and* butter"

foreign policy. The Gulf Cooperation Council states compensated the United States for its defense umbrella by exporting some 300 billion petrodollars to the United States out of a total of 530 billion (with another 100 billion to Europe, and only 60 billion to each of Asia and Middle East/North Africa).

Meanwhile, inside China, the surge of domestic credit (the other side of the surge of foreign exchange reserves) has blown out a credit bubble, which contributes to inflation at officially around 4–5 percent but unofficially more like 10 percent—including even faster food price inflation.[14] The inflation problem in China is now generating social unrest in many cities, prompting a military response.[15] The protests and riots in Tibet in March 2008 were misleadingly presented by the Chinese government, the Western media, and Tibet activists as being about Tibet resentment of Han Chinese colonization and human rights abuses. This resentment was certainly in the background, but the immediate cause was fast rises in food prices in the past several months. The food price inflation prompted monks and others to break into food shops, which were owned mainly by Han Chinese merchants. For the Chinese government, it is safer to present the Tibet riots in the well-established Tibet vs. Han Chinese frame than to acknowledge food inflation and food riots in many parts of China.

It is quite likely that China will have its own crash within the next year or two, for reasons to do with the unsustainable investment rate (40 percent of GDP), rising inflation, high unemployment despite fast growth, and social protest.

Alan Greenspan says in his autobiography, *The Age of Turbulence,* "I would place the U.S. current account [deficit] far down the list" of imbalances to worry about."[16] His judgment stems from the conviction that "markets are an expression of the deepest truths about human nature and . . . as a result, they will ultimately be correct."[17] Current events show his lack of concern about U.S. deficits to be a serious misjudgment. Monetary and fiscal policy could have reined in the deficit, and the world economy would have expanded more stably and more slowly. But U.S. authorities were careless about the consequences as long as the boom continued and rates of return in

the financial sector ran in the double digits, and as long as the United States could finance a guns *and* butter foreign policy.

An Overcomplicated and Ineffective Global Regulatory Structure

The existing global regulatory regime is very complex, with an incontinent number of bodies and obscure relationships between them.[18] New committees and working groups are continually added and few are taken away. There is no locus of leadership, as seen in the fact that the G7 finance ministers have paid little attention since creating the Financial Stability Forum in 1999. The composition of its governing bodies reflects the post–World War II balance of power in the global financial system.

The Basel Committee on Banking Supervision (established in 1974) is a microcosm. It comprises thirteen member states, of which ten are from Europe, including Belgium and mighty Luxembourg. The only Asian state is Japan. It does not include China or India, or any state in the southern hemisphere. Although charged with supervising the world's banking system, it is accountable to the G10 (in practice, 13) of central bank governors, a majority of whom have either no bank supervisory responsibilities or only marginal ones. In cases where banking supervision is organized separately from the central bank, the heads of banking supervision are not officially involved in the committee.

Again, in the International Organization of Securities Commissions (IOSCO), which is to securities markets what the Basel Committee is to banking, the key committee, where standards are set, includes two Canadian representatives but none from China or India.

Regulatory Response

Wisdom begins by recognizing that booms and busts have been part of capitalism from the beginning, because the market mechanism recurrently fails to stop capital transfer from exceeding the long-run capacity to repay interest and principal. Tighter and more comprehensive regulation may slow down financial innovation, but the possible benefits of innovation have to be weighed against the high social costs

of crises. It is clear that our present regulatory arrangements have deep flaws, both nationally and internationally.[19]

Finance should be put in the same frame as regulated industries like drugs, tobacco, firearms, and explosives.[20] Governments disallow the sale of these products in a free market because of the social costs associated with their use. They use a mixture of restricting access, imposing taxes, constraining advertising, and outright prohibitions. Keeping financial actors within the limits of prudence requires regulators to use a similarly robust range of policy instruments, differentiated by type of product, including quantitative ceilings, transaction taxes, restrictions on securitization, other direct inhibitions on financial transactions, and registration—at a minimum—of over-the-counter derivatives.

Positively Correlated Capital Structures

The fundamental challenge is to correct the current incentives which, in the words of *The Economist,* make bankers "lend . . . people umbrellas when the sun is shining and ask . . . for them back when rain starts to fall."[21] In other words, the challenge is to establish a global norm of positively correlated as distinct from inversely correlated capital structures.[22] A positively correlated capital structure is one where repayments are positively correlated with ability to repay: as ability to repay goes up, repayments go up, and as ability to repay goes down, repayments go down. Hence the provider of capital shares more of the risk, and the price of risk goes up.

Today, capital structures of countries and banks tend to be inversely correlated, such that as boom times roll on, the cost of credit goes down, and as conditions deteriorate, the cost of credit goes up. This generates procyclical momentum in the world economy, causing high levels of financial fragility and overshooting in both directions.

New Financial Instruments with Countercyclical Effects

One line of solution is to develop new financial instruments with countercyclical effects. An example is GDP-linked bonds (or "growth-

linked securities")—as GDP goes up, interest payments go up, and as GDP goes down, interest payments go down. The bonds should have a range of maturities, and institutional investors should have incentives to buy and hold rather than buy and sell. Other kinds of instruments with countercyclical effects include fixed-rate borrowings to be repaid not in foreign currency (like U.S. dollars) but in local currency; borrowings indexed to export earnings; borrowings inversely indexed to U.S. interest rates; and, of course, equity-like instruments.[23]

Countercyclical International Rules: Revise Basel 2 and IAS 39

Another line of solution is to renegotiate the new Basel 2 capital adequacy accord to hard-wire into it a countercyclical capital requirement. The Basel 2 agreement came into force at the start of 2008, after nine years of negotiation.[24] But it has fundamental flaws, only too clearly exposed by the current crisis. Above all, it runs against the principle that organizations that can expect a public safety net should not be left to regulate themselves, because "self-regulation plus public safety net" is a recipe for moral hazard. Whereas the Basel 1 rules imposed an externally set figure of capital adequacy, the Basel 2 rules give much more scope for self-regulation—including by organizations that know they are "too interconnected to fail."

More specifically, Basel 2 requires international banks to use their own internal risk-assessment models (approved by the Basel Committee) to calculate their own capital adequacy ratio. Yet these models have been shown to fail spectacularly in the run-up to the current crisis, sanctioning too-cheap lending and too few capital reserves (that is, "underpricing risk"). Basel 2 also requires banks to use rating agencies' ratings, which have also been shown to fail spectacularly. When Basel 2 is revised, Basel 3 should shrink the scope for self-regulation and should require governments to impose an additional tax on the banking system comparable to an insurance premium against future crises. The tax would be set countercyclically, higher in good times and lower in bad times. Basel 3 would spell out general principles and leave it to central banks to set the rate.

International Accounting Standard 39 also needs revision, because it, too, generates procyclical effects. It requires entities presenting financial statements to value assets at "fair value," which is a tendentious euphemism for present market value, as distinct from the earlier permission to carry the assets forward at their historical cost. It is clearly good for market integrity that assets be shown in financial statements valued at their recoverable value, and companies applauded IAS 39 as long as asset values were rising. But in downturns, the asset base keeps shrinking and the write-downs generate cumulative causation downward. That the standard was formulated without a countercyclical requirement owes a lot to the fact that the International Accounting Standards Board, created by the U.S. Securities and Exchange Commission and the European Commission in 2001 in the wake of the East Asian crisis,[25] is a professional body made up of accountants, whose attention is focused on companies and their marketplace transactions and not on the macroeconomic effects, such as procyclicality. Yet since the standard was announced in 2005, national governments have given it little legislative scrutiny before adopting it into national commercial law.

Capital Controls

Changing international rules will go only so far. With capital markets being so large and volatile, it is important that governments be able to fortify national defenses against destabilizing capital inflows and outflows. The standard prescription is for governments to rely on "strengthening national regulation" at the same time as they open the financial system. But the recent history of financial crises in *developed* countries shows how difficult it is to rely on regulation alone to maintain stability in the financial system, even when the regulatory regime is "strong." In 1991–92 Sweden experienced a financial crisis, which cost it some 6 percent of GDP to climb out of.

Capital controls can partially compensate for failures of both the market mechanism and prudential regulation, especially in developing countries. We need a change in global norms to permit capital

controls on inflows and outflows, whether in the form of quantitative restrictions or transactions taxes.[26] But we should not call them "capital controls," because the phrase provokes knee-jerk antipathy. Better to call them "capital management techniques." And we should make clear that capital management techniques do not imply that "countries [should] stay out of the waters of foreign capital," as distinct from "choosing to learn how to swim," in the false choice posed by two IMF officials.[27] Capital management techniques imply a strategic approach to capital flows, not turning away from them.

National Financial Regulation

One of the big questions concerns the appropriate scope of national regulation. Standard thinking makes a sharp separation between segments within the safety net of emergency public funding and segments outside the safety net, and says that the latter should continue to be unregulated except that they would be stopped from engaging in specific activities that could cause "systemic harm"—for example, selling credit default swaps to regulated banks and brokers.[28]

The counterargument is that any attempt to stop unregulated organizations from generating systemic risk is doomed to fail. The crisis shows that the explosion of complex financial instruments has made organizations so closely intermeshed in their mutual exposure to risk that the distinction between appropriately regulated and appropriately unregulated segments has broken down. The recent Bear Stearns rescue—where the U.S. central bank arranged for JPMorgan Chase to buy Bear Stearns at a fire-sale price (not least because JPMorgan Chase was the counterparty for many of Bear's derivative contracts and so was itself at risk if Bear Stearns went down)—shows how the range of organizations regarded as "too interconnected to fail" has expanded far beyond depository organizations.

Going forward, the regulatory structure, especially in the United States, needs to be joined up and a wider range of organizations brought within the scope of regulation. In particular, hedge funds and investment banks have to come within the regulatory net to curb

their propensity to generate bubbles. They should be put under higher margin requirements.

More broadly, the mandate of central banks should be changed to recognize that if it is their job to backstop the financial system in crisis, it is also their job to curb momentum toward crisis, which includes asset price inflation as well as consumer price inflation.

The rating agencies and the use made of their ratings need attention. First, they should not be paid by the issuers or sellers. Instead they might be paid by the investors or buyers of securities (although here a free-rider problem has to be faced, because later buyers might simply adopt the rating paid for by the earlier buyers). Or they might be made to turn themselves into nonprofit organizations. Or the supervisory agencies themselves might be made responsible for issuing credit ratings for the organizations under their supervision. The U.S. Federal Reserve already rates many of the organizations under its direct supervision, and a newly consolidated regulatory regime might extend the practice. Second, the same entity should not both rate products and advise on products. Third, the agencies should be required to do their own "due diligence" about the products they are rating.

Create a "Mixed Economy" in Banking and Finance

In the longer run, the banking and finance sector should be reformed to create a "mixed economy" in banking and finance, with some financial firms having a large component of public ownership or at least public guarantees. These firms would operate more like public or private utilities than as profit maximizers, with a mix of public and private purposes. Such a mixed economy in finance would help to discipline the private actors and promote "best practice," meaning practice that is not primarily about speculation, does not link management rewards primarily to speculative activity, and promotes enlightened corporate governance in the banking system. The component supported by public ownership or public guarantees would operate with a trading ethic that does not require them to drop unprofitable borrowers overnight.

One possible model is the cooperative banks of France and Finland.

There some of the retail banks own a centralized "wholesale" bank that is financed by the member banks and refinanced by bond issues or by its own deposits; and the wholesale bank ensures that losses on a particular retail bank are socialized among the members controlling the whole operation. Or the wholesale bank could be publicly owned or publicly guaranteed.

All these steps are likely to raise the cost of capital—and that is the point. The cost of capital should be more closely aligned with its risks.

Conclusions

Comparison of crisis indicators between previous crises in industrial economies and the United States in the run-up to 2007 suggests that the current one will be worse than most of the previous ones. But even if the downturn turns out to be mild—a few quarters of falling output in the United States, barely growing output in Europe, a few million people losing ownership of their houses, longer working hours and stagnant wages for most of the labor force, and not much effect on the rest of the world—the crisis has already thrown up important lessons that should inform the debate about reform.

For a start, the efficient-market theory, which has justified the push for liberalization, has been shown to be wanting. We have had competitive financial markets, but competitiveness has not generated efficient and stable financial markets (as distinct from very profitable markets). The externalities or interconnectedness with other parts of the economy are too big for political authorities to abide by the theory's prescriptions. Indeed, the record of previous crises shows that, even in industrial economies, financial liberalization is a leading indicator of future crisis.[29] True, the United States did not have much de jure financial liberalization in the 2000s. But the proliferation of originate-and-distribute transactions constituted a further de facto liberalization as barely regulated entities came to play a much larger role in the financial system, raising the vulnerability to certain kinds of shocks.

The originate-and-distribute business model—a specific institutional form of financial liberalization—has been shown to have substantial dysfunctional effects, which follow from the way it allows lenders to distance themselves from the consequences of their decisions and encourages them to believe that any new business is good business. The question is how to reform it without curbing innovation too much.

Another lesson is that the apparently sophisticated U.S. regulatory system is flawed in structure and functioning. Some of the flaws are so obvious—like the conflicts of interest of the rating agencies—that one wonders why regulators did not act to correct them long ago. The reason is contained in the answer to "Cui bono?" The gigantic profits made in the financial industry illustrate the adage that capitalism without regulation is banditry.

Still another lesson is that once a crisis is under way, even drastic cutting of central bank interest rates and massive injection of liquidity may have limited effects in stimulating credit markets and investment. The main effect may turn out to be the mother of all bubbles in the next several years, ending in a bigger crash. This underlines the importance of not letting bubbles develop in the first place.

Finally, the crisis shows the hazards of an economic growth model based on the growth of finance and housing, and on the international system's tolerance of large external deficits.

There is no shortage of ideas about new forms of regulation and new global financial norms. But what are the chances that anything beyond bandages will be applied? Certainly the U.S. Congress, the U.S. Treasury, the IMF, and the Financial Stability Forum are all actively discussing reform proposals. The East Asian crisis of 1997–98 prompted a similar outpouring of reform proposals, but once the crisis abated, the encroaching forces of complacency ensured that little was done beyond formulating a raft of new international standards of good practice. Few additional constraints were placed on market participants.[30]

The financial industry will attempt to use its formidable power over legislatures and regulators to ensure that few additional constraints are placed on it this time. Wall Street has more or less captured the U.S. Treasury. It will continue to insist that the line of solution is

more standards of good practice and more pledges of good behavior, but not more constraints.

With the crisis having questioned the stability of even well-institutionalized financial markets, the financial industry is especially worried that developing countries may draw the lesson that they should slow down the momentum toward full financial opening. The U.S. government is equally worried. From the U.S. standpoint, it is important that China give up the "developmental state," in which, domestically, Chinese state-owned banks support Chinese industry and, externally, China builds a renminbi bloc in East and Southeast Asia and special political-military links with major commodity suppliers. This developmental state model interrupts the primary U.S. competitive advantage, the ability to intermediate financial flows so that profits accrue disproportionately to U.S. entities. Over the 1990s the United States was able to contain the threat of this kind from Japan and South Korea (in Korea by encouraging the government to break the finance-industry link in the name of free market economics); but China is a bigger challenge and a richer prize.

Tensions will rise as the United States presses China to open its financial system at the same time as the United States experiences a political backlash against sovereign investment funds, including China's. Sovereign investment funds will be searching for U.S. assets other than low-yielding Treasuries or dubious asset-backed securities. Their purchase of U.S. icons will further fuel antitrade sentiment in the United States.

For those who look forward to a new world order in which the United States and the G7 have less power to set the agenda of global business on their own (even while the United States remains the "indispensable nation"), the crisis has a silver lining. The fact that it is the first crisis in history where hopes are pinned on growth in developing countries to rescue the world economy, and the first time that troubled banks in the United States and Europe have been rescued by capital injections from developing countries, should jolt the United States and the G7 out of their complacency about their own leadership and about the dominance of market fundamentalism. The crisis may be a stealthy

bridge-building event toward incorporating China and several other "emerging market" states as equal partners at the top table of global economic governance,[31] and toward a new approach to the role of political authorities in governing the market.[32]

Notes

1. Carmen M. Reinhart and Kenneth S. Rogoff, "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison," February 5, 2008. See also Nicolas Bloom, "The Impact of Uncertainty Shocks," NBER working paper 13385, National Bureau of Economic Research, Cambridge, MA, September 2007.

2. Asena Caner and Edward Wolff, "The Tragedy of Asset Poverty in the U.S.," *Challenge* 47, no. 1 (January–February 2004): 5–52.

3. But hundreds of thousands of Cambodians have been dispossessed of house and land in 2007 and 2008 in the backwash to the credit crunch. As money markets began to look shaky, speculators and investors fled east in search of tangible incarnations for their cash, and the communist government of Cambodia saw the opportunity to attract a flood of foreign exchange by selling beaches, islands, and virtually anything else to foreign and Cambodian super-rich. Taking "accumulation by dispossession" to new heights of barbarism, "Forty five per cent of the country's entire landmass has been sold off—from the land ringing Angkor Wat to the colonial buildings of Phnom Penh to the southern-western islands" (Adrian Levy and Cathy Scott-Clark, "Country for Sale," *Guardian Weekend*, April 26, 2008).

4. Jan Kregel, "Minsky's 'Cushions of Safety': Systemic Risk and the Crisis in the U.S. Subprime Mortgage Market," working paper, Levy Economics Institute of Bard College, Annandale on Hudson, NY, November 2007.

5. Tony Jackson, "Has the Supercharged Banking Model Run out of Control?" *Financial Times,* January 21, 2008. The United States and the UK have experienced the biggest increases in the share of the financial sector of the major economies, Japan the least. For example, between 1980 and 2006 the share of employment in finance in the UK rose from 11 percent to 22 percent; in Japan, from 3 percent to 4 percent. On the larger process of "financialization of the economy," see Robert Wade, "Globalization as the Institutionalization of Neoliberalism: Commodification, Financialization, and the Anchorless Economy," in *Institutions and Market Economies: The Political Economy of Growth and Development,* ed. W. Garside (Basingstoke: Palgrave, 2007), 250–77.

6. Robert Wade, "Globalization, Growth, Poverty, Inequality, Resentment, and Imperialism," in *Global Political Economy,* ed. John Ravenhill, 2d ed. (Oxford: Oxford University Press, 2008), 373–409.

7. Joanna Chung, "Multi-layered Patchwork Will Be Tough to Unpick," *Financial Times,* April 24, 2008, 13.

8. A former broker in the City of London described the unregulated world of high finance as he encountered it over the past ten years: "Behind the headline-grabbing stories of rogue traders losing billions, the more mundane, day-to-day world of high finance is as wild and unregulated today as it ever has been. . . . [T]he truth is that

everywhere corruption drips like honey. For all the talk of FSA [Financial Service Authority] controls, those working there know they can get away with abuses with barely a slap on the wrist—and so they do, day after day, year after year. . . . for all its bluster, the FSA—set up to regulate the industry—never did anything to address the suspicious moves in hundreds of share prices every week" ("Tricks of the Traders," *Guardian Weekend*, May 3, 2008).

9. "Hopes of Healing," *Economist,* May 3–9, 2008, 42.

10. Robert Wade, "The Financial Crisis: Burst Bubble, Frayed Model," openDemocracy, October 1, 2007, available at www.opendemocracy.net/trackback/3466/.

11. Jan Toporowski, personal communication, April 22, 2008.

12. Richard Duncan, *The Dollar Crisis* (Singapore: John Wiley, 2005); Robert Wade, "The Case for a Global Currency: Reining in the Dollar," *International Herald Tribune,* August 4, 2006.

13. UNCTAD, *Trade and Development Report,* 2007, table 1.6.

14. See Michael Pettis's blog at www.piaohaoreport.sampasite.com.

15. Philippa Malmgren, "The China-Tibet Inflation Black Swan and Global Implications," ATCA and Philanthropia Dialogue, March 19, 2008.

16. Alan Greenspan, *The Age of Turbulence* (New York: Penguin Press, 2007), 347.

17. This is Joshua Cooper Ramos's paraphrase in "The Three Marketeers," *Time,* February 15, 1999; see also Anatole Kaletsky's argument in "Is Global Finance out of Control? Yes: Wade, No: Kaletsky," *Prospect* (December 2007), available at www.prospect-magazine.co.uk/article_details.php?id=9918.

18. Howard Davies and David Green, *Global Financial Regulation* (Cambridge, UK: Polity, 2008), especially p. 33.

19. In a longer treatment one should also discuss monetary policy, exchange rate coordination, and the like. One should also discuss how to provide families that lose their houses with affordable housing once they move.

20. Dani Rodrik, "Financial Innovation: A Case of Aspirin or Amphetamines?" *Daily Star,* April 18, 2008, available at www.dailystar.com.lb/article.asp?edition_id=1&categ_id=5&article_id=91135/.

21. "Joseph and the Amazing Technicalities," *Economist,* April 26, 2008, 20, 23.

22. Michael Pettis, *The Volatility Machine* (Oxford: Oxford University Press, 2002).

23. John Williamson, best known as the articulator of the Washington Consensus, is to spend several months in 2008 working at the Bank of England on a scheme for GDP bonds.

24. Stefan Gerlach and Paul Gruenwald, ed., *Procyclicality of Financial Systems in Asia* (Basingstoke, UK: Palgrave, 2006).

25. The accounting standards were part of a larger thrust toward global financial standards after the East Asian crisis—when many companies whose financial statements said they were secure suddenly went bankrupt. The International Accounting Standards Board was mandated to create a "single set of high-quality and principles-based global financial reporting standards that are used throughout the world's capital markets. Whether you are in Toronto, Tokyo, Tampa or Turin, the accounting should provide the same answer for the same economic transaction." See "Prepared remarks of Sir David Tweedie, chair of International Accounting Standards Board, Apr 21, 2008," available at www.iasb.org/NR/rdonlyres/4B0C599D-7704–4A64–

8125-DD0D50B36DA5/0/Empire_Club_speech.pdf. See also Robert Wade, "A New Financial Architecture?" *New Left Review* (July/August 2007): 113–29; Gerlach and Gruenwald, *Procyclicality of Financial Systems in Asia*.

26. Gerald Epstein, Ilene Grabel, and K.S. Jomo, "Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future" (revised version of paper presented at the sixteenth Technical Group Meeting of the G-24 held February 2003, April 2003).

27. Simon Johnson and Jonathan Ostry, "The Flow of Money," Letters, *Economist*, May 3–9, 2008.

28. Gillian Tett and Krishna Guha, "The Cost of a Lifeline: Humbled Financial Groups Brace for More Regulation," *Financial Times*, April 24, 2008, 13.

29. Graciela Kaminsky and Carmen Reinhart, "The Twin Crises: The Causes of Banking and Balance of Payments Problems," *American Economic Review* 89 (1999): 473–500.

30. Wade, "A New Financial Architecture?"

31. To soften the representativeness–collegiality tradeoff, some current top-table states would have to be invited to merge their representation with others. Several European states are obvious candidates.

32. Robert Wade, *Governing the Market* (Princeton: Princeton University Press, 2004).

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